No. 11818

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

ANNIS VAN NUYS SCHWEPPE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

APPELLANT'S REPLY BRIEF.

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I.

Facts and Issue Involved.

There is no material discrepancy between the statement of facts in Appellant's Opening Brief and Respondent's Brief. Furthermore, both parties are in agreement that in view of the facts established in the Tax Court, this case involves the single issue of whether or not the $400,000 increase in the net assets of the Van Nuys Building Company constitutes "earnings or profits accumulated" in its hands. The ordinary presumption in favor of the Commissioner thus disappears, and the correct legal consequences of the facts must be determined independently of it. *Lawrence v. Commissioner,* 143 F. (2d) 456, at 459 (C. C. A. 9, 1944).

II.
ARGUMENT.

1. The Action of the Debtor Corporation With Respect to the Indebtedness Subsequent to the Date the Note Outlawed Is Not Conclusive Against nor Inconsistent With Appellant's Present Position, but Clearly Supports It.

Respondent argues that the action of the Van Nuys Building Company in paying interest on the $400,000 obligation between the date when it outlawed in 1920 and December, 1922, is conclusive; since the corporation deducted the payments as interest, it secured a tax advantage as the result; the Appellant is bound by this action and cannot now claim that the payments were anything other than interest.

This issue is not extremely important but the argument is completely specious. The Appellant is a stockholder in the corporation who had nothing to do with its action in deducting the payments to Susanna Van Nuys during this period as interest. Such action did not benefit Appellant. Rather it was disadvantageous to her mother who, by reporting the receipts as interest, paid income tax thereon, whereas, they would have been exempt if treated as dividends. This proceeding involves the tax character of the principal—the $400,000—and does not involve in any way the character of the payments termed "interest." If Susanna H. Van Nuys had taken a bad debt or loss deduction with respect to the $400,000, there would be some inconsistency in the position presently taken by Appellant

that from the corporation's standpoint the increase in assets was gratuitous. However, as pointed out in Appellant's Opening Brief, Susanna H. Van Nuys could not and did not take any such deduction because of the gratuitous character of the transaction. The instant facts fall far short of establishing an estoppel against the Appellant, and are certainly far different from those involved in the corporate entity cases cited on page 8 of Respondent's Brief, where a taxpayer organizes a wholly owned corporation and deals with it as such, and then attempts to regard it or disregard it at his will for tax purposes.

There being thus no basis for estoppel against Appellant, Respondent is faced with its own argument (Resp. Br. pp. 9, 10) that the "book treatment" is of "no moment." This may not be entirely true, but we have covered the point in our opening brief (pp. 36, 37).

Respondent's argument on this point carries only to the date of death of Susanna H. Van Nuys. Effective with death the corporate treatment of the matter was reversed. No further payments of interest were made and the note was written off to capital surplus. Logically, if the payments of interest and expensing of them as such on the corporate books established the indebtedness as being in existence to the date of death, the contrary treatment by the corporation for all times after death must equally establish the contrary, to wit: that the indebtedness was eliminated effective with death. However, the action of the corporation after death was more conclusive than its action prior to death.

The crediting of the amount to paid-in-surplus was not a mere self-serving declaration but had a definite effect on the corporation's tax liability. Certainly, thereafter the corporation could not have resumed making the periodic payments and charging them as interest. Furthermore, for the reasons stated in Appellant's opening brief, there is no question but that such entry was made in good faith and was in perfect harmony with sound accounting practice of that time and of all times since.[1] Of considerable significance, however, is the fact that the action of the corporation immediately after death evinced its clear intention to regard the liability as eliminated. This constituted its "claim of right" to the increase in its net assets. It is clearly settled that when a taxpayer receives funds under a claim of right they constitute income even though they are the subject of litigation, and even though in later years it might be required to repay them. *North American Oil Consolidated v. Burnet,* 286 U. S. 417, 76 L. Ed. 1197, 52 S. Ct. 613 (1932). The "claim of right" on the part of the taxpayer is an essential element of this doctrine, and is of particular importance in a case such as the present one. Here the taxpayer had the money but its note was outstanding. The statute had run and, therefore, it could not be required to pay the note. When it stopped paying interest immediately after

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[1] "Much weight will be given to the books of account of the taxpayer if they are kept in good faith." Vol. 2, "Law of Federal Income Taxation," Merten's. Section 12.15, p. 154.

death and credited the note to paid-in-surplus, this constituted a claim of right upon its part to the original funds free of the debt—acceptance by the donee under the present facts—thus requiring the elimination of the indebtedness to be given proper tax cognizance at that time. *Boston Consolidated Gas Co. v. Commissioner of Internal Revenue*, 128 F. (2d) 472 (C. C. A. 1, 1942). This case and the claim of right doctrine generally explain and support the rule and the cases cited from pages 25 to 28 of Appellant's Opening Brief. Consequently, the good faith treatment of the item after death as an eliminated liability is of extreme tax significance because under the law it requires the elimination to be given whatever tax cognizance should be given it at that time. It was thus a closed transaction prior to the later litigation and estate tax controversy.

2. A Gratuitous Increase in Net Assets Does Not Constitute Earnings or Profits.

Respondent's argument to the point that a gratuitous increase in net assets might be earnings and profits merits but brief consideration. It is true that certain items such as Government bond interest which are exempt as income in the hands of the corporation nevertheless constitute earnings or profits. This is so because the items are clearly "income", and are "earnings and profits" since they constitute a *return* of money invested in a business transaction. A gratuity, however, is not income at all either in a constitutional or statutory sense.[2]

> *McGill,* "Taxable Income", 1945, p. 390;
>
> *Edwards v. Cuba R. R.,* 268 U. S. 628, 69 L. Ed. 1124, 45 S. Ct. 614 (1925).

And, it is important to note that in the *Edwards case,* in speaking of certain subsidy payments, which involved considerably more element of consideration than the instant situation, the unanimous court used "profits" and "income" interchangeably, saying at page 623:

> "They were not profits or gains from the use or operation of the railroad, and do not constitute income within the meaning of the 16th amendment."

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[2]In the original Revenue Act of 1913 the broad definition of gross income in Section II B corresponding to the present Section 22(a) specifically provided that gifts were not gross income. In the later acts as a matter of statutory arrangement this specific provision was taken out of the section corresponding to Section 22(a) and was placed in a section corresponding to the present Section 22(b) providing that various items including gifts should "not be included in gross income." This is no indication that Congress had changed its view indicated by the 1913 Act to the effect that a gift was not income at all. *U. S. v. Supplee-Biddle Hdwe. Co.,* 265 U. S. 189, 68 L. Ed. 970, 44 S. Ct. 546 (1924).

In answering the general and accounting definitions of "earnings and profits" set forth in Appellant's Opening Brief, Respondents merely say that accounting concepts are not controlling in determining earnings and profits, citing the *Wheeler case,* 324 U. S. 542. It is important to note, however, that in that case the very reason why accounting concepts were not accepted was due to the Court's desire to reach agreement in the rules applicable in determining taxable income and in those applicable in determining earnings and profits. As a matter of fact, that opinion clearly indicates that but for such compelling policy of tax law consistency, accounting concepts should control. Since the increase in assets in the present case would not be income, the principle of the *Wheeler case* would require that they not be included as earnings and profits. As previously stated, accounting concepts and income tax concepts go hand in hand on this issue.

The two short excerpts from Mr. Rudick's article on earnings and profits in 89 *Penn. Law Rev.,* 865 (1941), referred to in Respondent's Brief at pages 14 and 18 are misleading. The first citation indicates Mr. Rudick feels that the proceeds of a cancellation of indebtedness should be included in earnings and profits. Actually, if his entire sentence had been quoted, it would be clear that he was merely referring to those types of cancellations which would constitute taxable income. There is no intimation that an elimination of indebtedness which is not taxable and which is of the character of the elimination presently involved would constitute earnings and profits. Mr.

Rudick's own language on the question of whether a gift constitutes earnings and profits is unmistakably clear (p. 882):

> "(c) Gifts, bequests and devises: In *Cummings v. Commissioner,* it is suggested by way of *dictum* that a gift to a corporation would constitute earnings or profits. Presumably, the same suggestion would have been made as to a bequest or devise. From the standpoint of sheer logic, it is difficult to support this conclusion. Although a gift, bequest or devise may increase surplus, it is not, according to common parlance, 'earned' nor is it a profit. Moreover, unlike life insurance proceeds, such an accretion is not a substitute for lost profits. While apart from legal considerations, a fairly good argument might be made for treating distributions from *any* source, other than paid-in capital, as 'dividends', it does not appear that Congress intended to go so far, since it limited 'dividends' to distributions out of post-1913 *earnings or profits.* Admittedly, Congress has power to tax a distribution out of a gift, bequest or devise to the corporation, but, as pointed out by Mr. Paul, we must not confuse 'what Congress may constitutionally do and what it has tried to do.' "

We come then to the *Cummings case,* 73 F. (2d) 477 (C. C. A. 1, 1935) and others involving the question of whether or not the proceeds of life insurance received by a corporate beneficiary tax free for income tax purposes should be included in its earnings and profits.

In all of the cases thus far reported involving this point there have been sufficient earnings and profits aside from

the insurance proceeds to cover the distribution in question and, therefore, the discussion pertinent for our purpose has been purely by way of *dictum.* The Tax Court's view is indicated by the case of *Isaac May,* 20 B. T. A. 282 (1930). It clearly indicated that if the proceeds received were not income at all (as is clearly so in the case of a gift), then they could not constitute earnings and profits. However, the Court indicated its preference for the view that the proceeds should be included as earnings since insurance premiums would have been deducted from earnings and profits, and it would only be fair that the insurance proceeds should be credited to the same account.

It is submitted that this view is completely sound and serves to distinguish the insurance proceeds case from the gift case where the corporation has furnished no consideration whatsoever for the gift it ultimately receives. The *Cummings case,* previously cited, involving this same issue, stressed the same point with respect to the premiums having been charged to earnings, and in that respect its *dictum* is sound. However, its broader view—its secondary *dictum* so to speak—that a gift would constitute earnings and profits is, it is submitted, completely contrary to the intention of Congress and the law on the subject.

In this respect, it is similar to the *Kirby Lumber case,* the prime authority of both the Tax Court and Respondent, 284 U. S. 1, 76 L. Ed. 131, 52 S. Ct. 4 (1931). In that case during the year 1922 the corporation had purchased in the open market for a purchase price aggregating $940,778.70 its own bonds of an aggregate par value

of $1,078,300. It retired the bonds so purchased and the Commissioner claimed that the difference between issue price and purchase price—$137,521—constituted taxable income. The Supreme Court agreed, Mr. Justice Holmes saying that "As a result of its *dealings* it made available $137,521.30 assets previously offset by the obligation of bonds now extinct." Thus, the facts in the *Kirby case* involved the normal financial "operations" of a corporation. It is common practice for corporations with securities outstanding to watch the market value thereof and from time to time purchase the same when they have the funds available and when the price is right. Hoagland, "Corporate Finance" (1947), p. 95. Through this financial phase of a corporation's operations it makes money. Usually a corporation makes money by buying property and selling it at a higher figure, but the short sales transactions in the securities and commodities markets are clear examples of operating profits in the reverse situation where the property is sold and later bought at a lesser figure. This is the *Kirby Lumber* situation and the profit resulting is an operating profit from financial operations similar to the operating profit from trading or the ordinary commercial activity of buying first and selling later.

The character of this sort of transaction as an ordinary "financial operation" ceases when the corporate debtor negotiates with the creditor and the debt is settled for less than face value. There is then a personal relationship between the debtor and creditor in which the debt is treated as a promise rather than a piece of property. Such a

personal cancellation of the indebtedness is gratuitous and under the *American Dental case* does not constitute taxable income. In the instant case the relationships between the corporate debtor and the creditor were of the closest family type and in our original brief we have pointed out the several reasons why the instant case is of a more definite gratuitous character than the *American Dental case.* In addition to those considerations it should be noted that in the *Kirby Lumber case* a profit of roughly 10% was made upon the purchase of the bonds. That is, the corporate debtor paid roughly 90¢ on the dollar. In the instant case, the corporate debtor paid nothing. The entire principal was eliminated.

The differences between the instant case and the *Kirby Lumber Company case* are thus fundamental, and can not be ignored as a matter of law. Surely it can not be said that a profit to a corporation from its financial operations on the open market is the same as a gratuitous elimination of the entire principal amount of indebtedness within a family corporation.

3. The Instant Question Is One of Law, Not of Fact, and Should Be Reviewed on the Merits by This Court.

In Appellant's Opening Brief three cases were cited directly in point on the above question. The principal one of these was the *American Dental decision,* involving a cancellation of indebtedness where the Tax Court was reversed with the statement that it was not "free to determine at will or upon evidence and without judicial review the tests to be applied to facts to determine whether the result is or is not a gift." Justices Jackson and Frankfurter dissented on that point. A few months later, with the personnel of the Court unchanged, Justice Jackson wrote the opinion in the *Dobson case,* and it is he and Justice Frankfurter who have been responsible for the broad dicta contained in subsequent cases as to the restrictive power of review over Tax Court decisions.

It is of extreme significance that while Justice Jackson freely criticized numerous preceding cases in the *Dobson* opinion, he made no reference to the *American Dental case,* nor has it been criticized, nor in any way mentioned in the decisions following the *Dobson case.* In Mr. Randolph Paul's careful and complete analysis of the *Dobson case,* he concludes that the principle of the *American Dental decision* is consistent with it and that the Supreme Court has done nothing to indicate that the *American Dental* rule has been changed. *"Dobson v. Commissioner;* Strange Ways of Law and Fact," 57 Harvard Law Review 753, at 838-839 (1944).

Nor need we remind this Court that Congress intended Circuit Courts to review issues such as are involved in the present case and as were involved in the *American*

Dental case. The procedural problem presently involved is controlled by Section 1141(c) of the Internal Revenue Code, which was introduced into the Statute in 1926. The Committee reports accompanying it there gave several examples of the "questions of law" which the Circuit Courts should review including "the proper interpretation and application of the statute or any regulation having the force of law." H. R. Report No. 1, 69th Congress, 1st Session (1926), 19; Senate Report No. 52, 69th Congress, 1st Session (1926) 36-37. There can be no doubt that Congress intended that the Circuit Courts should review a case such as the present, turning as it does upon the interpretation of the statutory phrase "earnings or profits." Such a conclusion would not have been questioned between 1926 and 1943, the date of the *Dobson decision.* And some eighteen months after the *Dobson decision* the Chief Justice felt it necessary to reiterate the Congressional intent and point out that "Since our decision in the *Dobson case* we have frequently re-examined, as matters of law, determinations by the Tax Court of the meaning of the words of a statute as applied to facts found by that Court." *Bingham's Trust v. Commissioner,* 325 U. S. 365, at 371, 89 L. ed. 1671, 65 S. Ct. 1232. Consequently, the intention of Congress is perfectly in accord with the controlling cases directly in point.

Respondents have made no attempt to answer or distinguish the *American Dental case* or other cases directly in point cited in Appellant's Opening Brief, nor to explain why the intention of Congress should be disregarded, but have countered with general statements made in cases far different on the facts from the instant one. Nothing more

need be said. It is useless to examine dicta when the controlling statute and cases directly in point unanimously and conclusively decide the actual issue. Furthermore, the broad, general dicta cited by Appellant have been violated by the Appellate Courts on numerous occasions since the *Dobson case.* Even Justice Frankfurter is guilty of this. Note his consideration on the merits of the unique combination of facts involving a claimed waiver in *Angelus Milling Co. v. Commissioner,* 325 U. S. 293, 89 L. ed. 1619, 65 S. Ct. 1162 (1945).

In the *Seattle Brewing Co.* and *Rainier Brewing Co. cases,* 165 F. (2d) 216-217 (C. C. A. 9, 1948), ruled upon by Respondent, the Tax Court had not merely interpreted a written contract, but, as this Court specifically pointed out on re-hearing, there were considerable testimony and other facts adduced at the hearing which the Tax Court weighed in reaching its decision. Furthermore, those cases involved a very unusual and complicated business arrangement involving trade names which partook of many of the elements of a sale and many of the elements of a license. If this Court had treated the issue as one of law, the precedent would have been of little value because no clear-cut legal principle had emerged, and in the next comparable situation in which one factor might be added or subtracted an appeal to the Circuit Court would be necessary to determine whether that was the factor which might prompt an opposite decision. In neither the *Brewing cases* nor the *John Kelly case,* 325 U. S. 287 (1945) could any legal issue be stated without including in the statement all of the numerous criteria involved in that particular case.

This is not so in the instant case. Several clear-cut legal issues emerge with respect to which a precedent is needed and would be of considerable aid in subsequent cases involving the constant problem of elimination of corporate indebtedness. The first general legal issue is whether or not a gratuitous increase in the net assets of a corporation constitutes earnings or profits. The next general legal issue is whether or not a gratuitous increase can result from passivity as well as activity. The final general legal issue is whether or not a gratuity is altered for tax purposes by the fact that subsequent litigation confirms it. All three of these are vital, general legal principles. Numerous cases convincingly support Appellant's position on each of them.

It is of utmost significance that the Tax Court, in holding for the Respondent, has not made a single finding of fact contrary to any arguments advanced by Appellant or this Court. It has not—because it could not under the evidence—find that Susanna Van Nuys had no donative intent toward her corporation. Rather its entire theory is that the delivery element of a gift was lacking since no gift could be accomplished by passivity and the running of the statute; so the benefit must have been created by the successful litigation. Thus its conclusion is beyond the realm of the facts and is based on two general legal principles, both of which are clearly erroneous.

Respectfully submitted,

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